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No. 90-664

In the Supreme Court of the United States

OCTOBER TERM, 1990

QUALITY INNS INTERNATIONAL, INC., ET AL., PETITIONERS

v.

L.B.H. ASSOCIATES LIMITED PARTNERSHIP AND FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the debtor's plan of reorganization under Chapter 11 of the Bankruptcy Code satisfied the absolute priority rule when petitioners' unsecured interests were not paid in full, but the debtor's general partners who retained their partnership interests were required to reduce their senior secured claims or to make an equivalent cash contribution.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is not reported. The opinions of the district court and the bankruptcy court (Pet. App. 17a-65a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 26, 1990. The petition for a writ of certiorari was filed on October 23, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. L.B.H. Associates Limited Partnership (L.B.H.) filed a petition for reorganization under Chapter 11 in the United

States Bankruptcy Court for the District of Maryland. The sole asset owned by L.B.H. was the Lord Baltimore Hotel, which was operated by petitioners under a Management Contract and Franchise Agreement (Agreement). In connection with the bankruptcy, L.B.H. moved to terminate the Agreement with petitioners. L.B.H. also filed several plans for reorganization. The bankruptcy court confirmed the third such plan, over petitioners' objections. Pet. App. 3a-4a, 45a, 49a, 54a-55a, 61a.[1]

L.B.H.'s reorganization plan divides creditors' claims into several classes. Class 7 consists of the secured claims of L.B.H.'s general partners. Class 10 consists of the unsecured claims of petitioners. Class 14 consists of claims representing the partnership interests owned by L.B.H.'s general partners. Under the plan, L.B.H.'s general partners may retain their partnership interests in Class 14 in exchange for the partners' reduction of their Class 7 claims by $262,500, their provision of a contribution in cash in that amount, or their provision of any combination of cash and reduction of Class 7 claims totalling that amount. Petitioners objected to this aspect of the plan, contending that it violates the "absolute priority rule." Pet. App. 8a-9a, 33a.

The absolute priority rule as embodied in the Bankruptcy Code provides that with respect to dissenting unsecured claims that are impaired by the plan of reorganization, a plan shall not be approved unless it is "fair and equitable," a condition that includes the requirement that

> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

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[1] The FDIC participated in the reorganization proceedings because it holds mortgages or liens on property of the Lord Baltimore Hotel. Pet. App. 28a-29a, 57a.

> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. 1129(b)(2)(B)(i) and (ii). In essence, a plan that diminishes the value of senior creditors' unsecured claims may not be "crammed down" over their objections unless the plan eliminates the interests of junior creditors. Petitioners argued that L.B.H.'s plan improperly permits the general partners to retain interests that are junior to petitioners', while petitioners' claims were not being paid in full. The bankruptcy court rejected that argument, finding that the general partners "will not receive or retain under the Plan any property on account of such junior claim or interest." Pet. App. 57a.

2. The district court likewise disagreed with petitioners' objection based on the absolute priority rule, and it affirmed the bankruptcy court's confirmation of the plan. Pet. App. 17a-37a. Although agreeing with petitioners that their claims were not being paid in full while the general partners were being allowed to retain their partnership interests, the court believed that the plan satisfied an exception to the absolute priority rule. The court explained that petitioners had failed "to take into account that in order to retain these interests the general partners must pay cash or give up the equivalent in secured claims." Consequently, the general partners were "required to put in new money or money value into the estate for the benefit of other creditors." *Id.* at 33a. The court rejected petitioners' argument that the contribution made by the general partners here was analogous to the "sweat equity" contribution that this Court found insufficient in *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197 (1988), to justify allowing the owners of a bankrupt enterprise to retain an interest in the enterprise despite creditors' objections. Pet. App. 33a.

3. The court of appeals affirmed in an unpublished, per curiam decision. Pet. App. 1a-16a. Although petitioners raised six issues on appeal, they did not question the concept that owners who contribute "new money" may retain their interests under an exception to the absolute priority rule. Rather, petitioners objected to the general partners' retention of their interests solely on the theory that the particular contribution required in this case did not constitute "a contribution of new money or money's worth within the exception to the absolute priority rule." Pet. C.A. Br. 27-28; Pet. C.A. Reply Br. 11-13.

The court of appeals rejected that contention, explaining that the general partners received their partnership interests in exchange for a capital contribution of $262,500, consisting of any combination of cash and reduction of the Class 7 claims. Pet. App. 9a. The $262,500 contribution, the court thought, validated the partners' retention of their interests because it constituted "a current contribution of 'money or money's worth,'" *ibid.* (citing *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 121-122 (1939)), and because the contribution was "necessary" to the success of the reorganization. Pet. App. 9a (citing "projected cash flow statements").

ARGUMENT

Petitioners contend (Pet. 4-9) that, on the particular facts of this case, the court of appeals misapplied the doctrine that the contribution of "money or money's worth" may permit the owners of a bankrupt enterprise to retain their interests despite the objection of senior creditors whose claims are not paid in full. The court's rejection of that factbound contention, announced in its unpublished decision, raises no issue worthy of this Court's review.

1. The absolute priority rule expresses the policy that dissenting, unsecured creditors must be paid in full before a junior interest can receive or retain property by virtue of

a plan of reorganization. *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 202 (1988). The requirements of the absolute priority rule are now embodied in Chapter 11 of the Bankruptcy Code, enacted in 1978. 11 U.S.C. 1129(b)(2)(B)(ii). Before the enactment of the Code, this Court suggested that an exception to the absolute priority rule would exist when the owners of the bankrupt enterprise make a contribution of "money or money's worth, reasonably equivalent in view of all the circumstances to [their] participation," and when equity holder participation is necessary to gain the infusion of new capital into the enterprise. *Case* v. *Los Angeles Lumber Products, Co.*, 308 U.S. 106, 117, 121-122 (1939) (dicta). In such a case, the Court explained, the equity holder may participate in the reorganized enterprise even though the claims of creditors are not fully honored and those creditors do not consent to such participation.

In *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197 (1988), this Court assumed, without deciding, that the exception described in *Los Angeles Lumber* survived the enactment of the Bankruptcy Code, but the Court went on to hold that it did not apply to an owner's commitment to contribute "labor, experience, and expertise" in running the enterprise under reorganization. *Id.* at 203 & n.3. The Court explained that those forms of contribution were inadequate to satisfy the new-value exception to the absolute priority rule discussed in *Los Angeles Lumber* because the "promise of future services is intangible, inalienable, and, in all likelihood, unenforceable." 485 U.S. at 204. Rather than constituting an infusion of capital that immediately enhances the enterprise's value, "a promise of future services cannot be exchanged in any market for something of value to the creditors *today*." *Ibid.*

Petitioners rely (Pet. 6-7) on *Norwest Bank Worthington* in arguing that the "particular plan" approved in this case

does not involve an infusion of new capital into the debtor. Petitioners do not contend that the cash contribution contemplated as one option under the plan would not be "money or money's worth" for purposes of the *Los Angeles Lumber* exception. Rather, they argue that the option for the owners to cancel their secured claims is not new value that allows them to retain their equity interests.

But the forgiveness of a higher priority debt may constitute "money's worth" within the meaning of the *Los Angeles Lumber* exception. As the court explained in *In re Future Energy Corp.*, 83 Bankr. 470, 498 (Bankr. S.D. Ohio 1988), "if the transaction in question both benefits the debtor and places the shareholder in a position of economic risk, a capital contribution within the meaning of [*Los Angeles Lumber*] and its progeny shall be deemed to have been made." *Future Energy Corp.* held that the forgiveness of secured debt benefits the debtor and imposes economic risk on the owner, thus satisfying the requirements of a capital contribution for purposes of the "money's worth" exception. 83 Bankr. at 498. The same analysis applies here. The general partners of L.B.H. were given the option of relinquishing secured claims, senior to petitioners' claims, as a condition of retaining their ownership interests. By cancelling their security interests and accompanying claims on the debtor's assets, the general partners contributed "money or money's worth" to the debtor just as surely as if they had paid money into the debtor's estate for it to use in extinguishing the secured debt.

The surrender of secured debt here bears scant resemblance to the promise of future services found wanting in *Norwest Bank Worthington* v. *Ahlers*. In that case, the owners of the enterprise were essentially offering nothing but their willingness to continue working towards the success of the venture under reorganization. Such an interest cannot be translated into a quantifiable benefit to the

creditors of the enterprise; as the Court explained, it is not an asset that can be booked on the entity's balance sheet. 485 U.S. at 204. But the forgiveness of higher-priority secured debt immediately frees up an asset for inclusion on the entity's books, because it removes the lienholders' interest in the property in question. Where, as here, "these contributions are necessary to the success of the undertaking," Pet. App. 9a, they satisfy the exception to the absolute priority rule as delineated by *Los Angeles Lumber*.[2]

2. A more important issue – not raised by petitioners – is whether the *Los Angeles Lumber* exception to the absolute priority rule survives the enactment of the Bankruptcy Code.

In *Norwest Bank Worthington* v. *Ahlers*, we argued that this "money or money's worth" exception was eliminated by the Bankruptcy Code. This Court concluded that the exception did not apply on the facts of that case, and left for another day the issue of "the continuing vitality of the *Los Angeles Lumber* exception." 485 U.S. at 203 n.3. We continue to believe that the Bankruptcy Code abolished the "money or money's worth" exception, but, for three reasons, we do not believe that that issue warrants review here.

First, petitioners have never raised the question of *whether* a "money or money's worth" exception exists, as opposed to *how* it applies in this case. The thrust of petitioners' argument has been to acknowledge the validity of the exception, but then quarrel about its dimensions and requirements. See

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[2] Although petitioners assert (Pet. 9) a need for this Court's guidance on the implications of the *Los Angeles Lumber* exception, only two cases of which we are aware have involved the question of whether the cancellation of secured debt satisfies that exception – this decision and *Future Energy Corp.* We see no need for the Court to clarify the scope of *Los Angeles Lumber* in such a comparatively unusual setting, where no conflict of authority is even alleged to exist.

Pet. C.A. Br. 27-28; Pet. C.A. Reply Br. 11-13.[3] Accordingly, the court of appeals was given no reason to consider the deeper issue of whether the Bankruptcy Code changed the legal context in which the absolute priority rule operates, with the effect of rejecting the dicta in *Los Angeles Lumber*. Understandably, the Fourth Circuit's per curiam opinion does not allude to that issue.

Nor does the petition present the question of whether the "money or money's worth" exception enjoys continuing validity. Rather, the petition assumes that the exception is valid, and then goes on to discuss its contours and rationale. Pet. 6. In light of petitioners' failure to challenge the existence of the exception, this Court may deem that contention waived. The "general rule" is that "a federal appellate court does not consider an issue not passed upon below," *Singleton* v. *Wulff*, 428 U.S. 106, 120 (1976), and there is nothing exceptional about this case that warrants departure from that principle. See *Hormel* v. *Helvering*, 312 U.S. 552, 557 (1941).

Second, the courts of appeals have had comparatively few opportunities to consider the issue left open in *Norwest Bank Worthington*, and it has as yet generated no conflict in the circuits.[4] One court of appeals recently urged the view that the *Los Angeles Lumber* exception does not survive the Code, but the court "stop[ped] short" of deciding that question because it concluded that the value contributed in that case did not satisfy the "money or money's worth" require-

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[3] The FDIC, represented by outside counsel without the participation of the Department of Justice, confronted petitioners' arguments on their own terms, and did not raise the question of whether the *Los Angeles Lumber* exception survived the enactment of the Bankruptcy Code.

[4] As the Court noted in *Norwest Bank Worthington*, bankruptcy judges have been divided on the issue for some time. 485 U.S. at 203-204 n.3.

ment as expressed in *Norwest Bank Worthington. Kham & Nate's Shoes No. 2, Inc.* v. *First Bank of Whiting*, 908 F.2d 1351, 1359-1363 (7th Cir. 1990); see also *In re Stegall*, 865 F.2d 140, 142-144 (7th Cir. 1989). Other circuits, like the Fourth Circuit here, have apparently not focused on the question. See, *e.g*, *In re Blankemeyer*, 861 F.2d 192, 194 (8th Cir. 1988) (finding owner's proposed contribution inadequate to justify retention of ownership interest without questioning the validity of *Los Angeles Lumber*). Although we believe that this Court should review the validity of that exception in an appropriate case, absent a conflict in the circuits we see no pressing need to do so here.

Third, although it is our view that the exception to the absolute priority rule applied by the court of appeals is not a valid one, we do not suggest that the Court remand the case for further consideration of that issue. Because the Fourth Circuit's unpublished decision establishes no precedent, the opinion below will not hinder reconsideration of the "money's worth" exception when a dissenting creditor actually chooses to litigate that issue, as petitioners did not. And, as a prudential matter, it is quite late in the day to unravel the reorganization plan adopted in this case.[5]

Litigation by petitioners challenging the reorganization has been protracted and vigorous. As the district court ruefully observed, objections (by petitioners and others) proliferated "because there seems to have been a scorched earth policy in the litigation of this case." Pet. App. 19a. Petitioners have resisted the bankruptcy court's effort to make the Lord Baltimore Hotel function again as a viable economic entity, through numerous appeals, raising

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[5] The bankruptcy judge observed that "[a]ll of us have invested parts of our lives in this case. I will always remember 1988 as the year of the Lord Baltimore case." Pet. App. 50a.

numerous issues. In a careful opinion, the court of appeals rejected each of the many claims that petitioners urged upon it, as had the district court before it. At this juncture, the settled expectations of the parties, and the long efforts devoted to making the reorganization a success, weigh against reversing the judgment for consideration of a legal issue that petitioners have never elected to assert.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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